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STATE PASS TO USTR (EISSENSTAT/MELLE)
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E.O. 12958: N/A
TAGS: ECON ELAB EFIN PINR PGOV MX
SUBJECT: MEXICO'S CALDERON UNVEILS TAX REFORM PROPOSAL

REF: MEXICO 2518

Summary and Introduction

¶1. (SBU) On June 20, President Felipe Calderon submitted to the Congress Permanent Standing Commission a fiscal reform proposal that focuses on boosting government revenues and combating tax evasion. The initiative aims to increase federal tax collection by 1.9 percent of GDP and state collection by 0.9 percent -- bringing the non-oil tax intake from 10 percent of GDP to about 13 percent by 2012. The proposal includes a new alternative minimum tax designed to close loopholes companies use to reduce their tax payments, a 2 percent levy on monthly cash bank deposits of more than 20,000 pesos (USD 1,835), and measures to fight tax evasion. The proposal does not levy food and medicine or cut back on generous special tax regimes. The process of building consensus for this proposal will be more difficult than it was for pension reform. President Felipe Calderon needs support from opposition parties in Congress, notably the PRI, to secure the reform's passage. Private sector organizations have already expressed concern that the new alternative minimum tax could impede job creation. Calderon has a strong chance of passing fiscal reform, though the proposal sent to Congress is likely to be modified. Although Calderon's tax reform proposal is an important step forward for Mexico, it is not as comprehensive or bold as many would have liked given that Mexico has the second worst tax collection rate in Latin America after Guatemala. End Summary.

The Government's Proposal

¶2. (U) The Calderon government's fiscal reform proposal centers on a new alternative minimum tax (called the CETU) designed to prevent companies from using deductions and loopholes to significantly reduce their tax payments. This tax replaces the 1.25 percent tax on assets, and would

require companies to pay the higher of the CETU and the current corporate tax of 28 percent. The CETU rate will be 16 percent in 2008 and 19 percent starting in 2009, but the new system reduces the number of deductions. Importantly, companies would not be allowed to deduct the cost of labor from income, meaning that more labor-intensive operations may see their tax bill increase. Business groups have already been vocal in opposition to this particular change, arguing that it will hurt job creation. A government press release says the tax will not harm employment since it is being complemented by an employment credit. Since the tax allows for deducting investments, it should help foster competition and development. The CETU aims to generate additional income equivalent to 1.8 percent of GDP.

¶3. (SBU) The reform seeks to impose taxes on the informal economy in an indirect manner. It introduces a 2 percent tax that would be assessed on cash bank deposits that exceed 20,000 pesos (USD 1,835) in one month. Individuals and companies would be able to credit the outlays for this tax against income taxes. Banks will be responsible for collecting the tax, taking into consideration the various accounts opened by an individual. The levy will not be imposed on diplomatic or consular agents or NGOs. While this measure will not significantly increase government revenues, it will help reduce tax evasion. Some analysts have expressed concern that the initiative will discourage workers in the informal economy from using banking services.

¶4. (U) The reform obliges taxpayers to report any loan, donation, or an increase in capital of more than 600,000 pesos (USD 55,000). To simplify the payment of the income tax for individuals and professional activities, the salary

credit will be eliminated and replaced by an employment subsidy, which will benefit those with lower income (less than 7,000 pesos/USD 640 per month). The size of the subsidy depends on the individual's salary.

¶5. (U) The proposal introduces a 20 percent tax on lotteries and gambling-related income, and a 50 percent tax on aerosol paints. In an effort to improve tax collection at the local level, it gives state and local governments the authority to levy products that are subject to the federal Special Tax on Production and Services (IEPS). This includes such products as gasoline, tobacco, and alcohol. The application of these taxes is subject to the approval of local legislatures.

¶6. (U) The reform also gives the Tax Administration Service (SAT) more teeth to fight tax evasion. The proposal would allow SAT to examine the operations of people who deposit more than 1 million pesos (USD 91,700) in their accounts in a year but have not accounted for the corresponding tax payments. It establishes that individuals and companies must present documentation that SAT requests during an audit. Currently, many wait until they are taken to court to produce this paperwork. It also proposes making senior managers of companies responsible if they omit information during an audit.

¶7. (U) The government's proposal leaves the basic income tax rate at 28 percent for companies and individuals, and does not attempt to levy food and medicine. Tax exemptions and special treatments for the agricultural sector remain unchanged.

Proposal Likely To See Markups Before Passage

¶8. (SBU) The process of building consensus for this proposal is likely to prove more difficult than it was with pension reform. Calderon needs support from opposition parties in Congress, notably the PRI, to secure the reform's passage. Private sector organizations have already expressed concern

that the CETU could impede job creation, and some pundits have pushed for a better way to accomplish the same fiscal objectives. Calderon has a strong chance of passing fiscal reform, though the proposal sent to Congress is likely to be modified. The government would like the reform to be approved during an extraordinary session of Congress this summer so the new measures can be incorporated into the President's 2008 federal budget proposal, which is due to the Chamber of Deputies on September 8.

Comment

¶9. (SBU) Calderon's tax reform proposal is an important step forward for Mexico, but it is not as comprehensive or bold as many would have liked. It was designed to be both economically sound and politically feasible, but the latter seems to have prevented the government from addressing a number of key issues. The proposal fails to simplify the tax system in a meaningful way or get rid of many generous special tax regimes, measures the government had previously identified as key components of a fiscal reform. The measures to improve tax administration are helpful, but could have gone further. Moreover, the reform does not address the transparency and efficiency of spending at the local level. As expected, the reform does not attempt to tax food and medicine or solve the state energy company's fiscal woes. Further tax reform will be needed to provide the government the steady flow of revenue it needs to address poverty and other growing social needs, and to avoid a potential fiscal crisis down the road due to declining oil production. End Comment.

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